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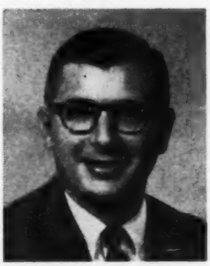
Junior Barristers' Page

By ROBERT H. INGRAM



Robert H. Ingram

This issue of the Bar Bulletin is being published by the Junior Barristers in connection with our Annual Essay Contest. We wish to express our thanks and appreciation to Justice Allen W. Ashburn, whose annual award to the winner of the contest has done a great deal to stimulate interest in it, and to our judges this year, Justice Roy Herndon of the District Court of Appeals, Judge Harold Schweitzer of the Superior Court and Professor Edward Jones of the U.C.L.A. School of Law.

The annual publication of an issue of the Bar Bulletin is of course only one of the many activities in which the Junior Barristers engage during the year. We have tried to encourage the participation of younger attorneys in the many public service activities of the Los Angeles Bar Association, the State Bar and the American Bar Association, and our members are on many of the busy and useful committees of these organizations. The membership of some of these committees, such as the Federal Indigent Defense Committee of the Los Angeles Bar Association, is primarily composed of Junior Barristers.

We also try to promote an active social program for our younger lawyers. Our activities along these lines this year have included

cocktail parties and dinners, in addition to our regular monthly luncheon meetings. We also took an active part in the planning and preparation for the Junior Bar Conference and the American Bar Association Convention here last August, and during the Convention, supplied much of the manpower and time that helped make it a success. This fall and next spring, we are planning several additional events, including our Annual Banquet and a weekend outing to some resort area.

Our monthly luncheon meetings, of course, constitute our principal social and educational activity. In addition to giving our members an opportunity to acquire practical knowledge and information, these meetings promote our members' acquaintance among themselves and with the older members of the bench and bar who address us. This is probably our most important contribution in the long run, as it helps maintain a more effective Bar, able to accept the responsibility for improvement of the administration of justice. I might add that I have found a consistent willingness on the part of Los Angeles judges and attorneys to give freely of their time and talents in order to give us the benefit of their knowledge and experience, and I speak for all of the Junior Barristers in thanking our speakers, one and all.

In conclusion, I should like to add a personal note. It is one of the duties of the Chairman of the Junior Barristers to serve, ex officio, as a member of the Board of Trustees of the Los Angeles Bar Association, and I would be remiss if I did not take this opportunity to thank the other Trustees, jointly and severally, not only for the wonderful cooperation and assistance they have at all times given the Junior Barristers, but also for their dedicated service on behalf of all members of the Association. I certainly had no idea of the time and the effort that these men expend every week on your behalf, without compensation, and solely because they actually believe that "every man owes some of his time to the upbuilding of the profession to which he belongs." It has been an honor and a real privilege to serve with them, and I hope that this expression will be instrumental in bringing to your attention how deeply deserving they are of your gratitude and appreciation.

Continuing Legal Education Program

FALL LECTURE SERIES

Your Bar Association is again sponsoring the State Bar's continuing legal education program. The fall 1958 lecture series is on "Presenting Evidence in Court." It will be given in the Auditorium, California Teachers Association Building, 1125 West Sixth Street, Los Angeles.

You will have your choice of attending either the weekend or week-night session.

Week-Night Session—Thursdays-Tuesdays

November 13, 7:30 p.m.—1. How to Offer and Object to Evidence. Elmer Low, lecturer.

November 18, 7:30 p.m.—2. Practice in Examining Witnesses. Hon. Alfred Gitelson, lecturer.

November 20, 7:30 p.m.—3. Expert Testimony. Otto M. Kaus, lecturer.

November 25, 7:30 p.m.—4. Admitting and Using Demonstrative Evidence. Ingall W. Bull, Jr., lecturer.

December 2, 7:30 p.m.—5. Use of Documentary Evidence and Depositions. Frank J. Breslin, Jr., lecturer.

Weekend Session—Friday-Saturday

December 12, 1:00 p.m.—1. How to Offer and Object to Evidence. Hon. John F. Aiso, lecturer.

December 12, 3:30 p.m.—2. Practice in Examining Witnesses. Allen E. Susman, lecturer.

December 12, 7:30 p.m.—3. Expert Testimony. John T. Binkley, Jr., lecturer.

December 13, 9:00 a.m.—4. Admitting and Using Demonstrative Evidence. Hon. Leon T. David, lecturer.

December 13, 11:15 a.m.—5. Use of Documentary Evidence and Depositions. Robert M. Newell, lecturer.

This series is offered through the facilities of University Extension. Attorneys in general practice are particularly urged to attend.

The registration fee is $18.00, which includes Witkin's 800-page book on California Evidence. The writing of this book has just

been completed and it contains an up-to-date discussion of California cases and statutes on evidence—an invaluable aid for quick authoritative research when preparing and trying cases.

Registration can be made through University Extension, 813 South Hill Street, Los Angeles 14. If you have any questions, please communicate with your local bar representative, who is Leslie C. Tupper, 605 West Olympic Boulevard, Los Angeles 15. (MA 7-5111). Please indicate whether you prefer the week night or week end session.

Registration Form

(This form may be forwarded to University Extension, 813 South Hill Street, Los Angeles 14, or registration may be made in person at the Auditorium, California Teachers Association Building, 1125 West Sixth Street, Los Angeles.)

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JUNIOR BARRISTERS ESSAY CONTEST

The Avoiding Powers of a Trustee in Bankruptcy

By GEORGE M. TREISTER*
First Place Winner
1958 Junior Barristers Essay Contest

Bankruptcy, like death and taxes, seems to be permanently with us. Except for periods of all-out war, and immediate post-war boom, when even the most marginal operators are able to get along, and periods at the depth of a major depression, when all credit has been squeezed from the economy, business failures steadily occur in good times as well as in bad. This has been proved recently by the fact that as the population increased, the incidence of bankruptcy increased, despite the relatively prosperous years between World War II and the current recession.[1]

Under-capitalization and inadequate management probably are the most frequent causes of the failures. On the upswing of the business cycle, these factors lead to an over-expanded or over-extended position, and trouble follows; on the downturn of the cycle, the tightening of credit and intensified pressure of competition force the same result.

But whatever the causes, bankruptcies occur with tragic regularity; attorneys advising business clients, therefore, should always consider not only the tax consequences of any transaction, but also the possible impact upon it that the other party's bankruptcy will have. Lawyers generally are aware of the risk that the person with whom the client is dealing may seek relief under the Bankruptcy Act and obtain a discharge of his obligations.[2] Less familiar, perhaps, are some of the other perils. Important in this connection are those provisions of the Bankruptcy Act which con-

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[1]The Tables of Bankruptcy Statistics, published by the Administrative Office of the United States Courts, show that since 1947 the total annual filings under the Bankruptcy Act, for the fiscal periods ending June 30th of each year, have increased as follows: 1947: 13,170; 1948: 18,510; 1949: 26,021; 1950: 33,392; 1951: 35,193; 1952: 34,873; 1953: 40,087; 1954: 53,136; 1955: 59,404; 1956: 62,086; 1957: 73,761.

[2]The discharge will act as a bar to all the bankrupt's provable debts, except those which are specifically declared non-dischargeable. Bankruptcy Act, Sec. 17. Among the non-dischargeable obligations are tax claims; fraudulently incurred debts; alimony; wages earned by employees within 3 months before bankruptcy; debts arising from wilful or malicious injury to the person or property of another; and claims which are not scheduled in bankruptcy, unless the claimant had actual knowledge of the proceedings.

fer upon the Trustee the so-called "avoiding powers," i.e., the power to set aside or invalidate certain transfers, liens or encumbrances.[3] It is hoped that a review of these will provide a check list which may prove helpful in anticipating what otherwise might be unpleasant surprises.

Power to set aside transfers voidable under state law by the bankrupt's creditors. Section 70e of the Bankruptcy Act gives the Trustee the power to set aside any transfer made by the bankrupt which, under applicable state law, is voidable for any reason by a creditor holding a provable claim.[4] "Transfer" is defined broadly to include not only the outright disposition of assets, but also the creation of a security interest or lien of any kind upon property.[5]

On a first impression it might seem that since the avoiding power under Section 70e is based upon state law, a person dealing with a prospective bankrupt has no more to fear from the Trustee in Bankruptcy than from the creditors themselves. But this is not true for at least two reasons, one practical and the other legal. The first is that although creditors frequently have the right under various statutes to invalidate certain transactions had between their debtor and a third party, the reported cases would indicate that they rarely exercise this right outside of bankruptcy. Perhaps their lack of familiarity with the technical laws which protect creditors accounts for this phenomenon. A Trustee in Bankruptcy, on the other hand, is differently oriented. One of his primary concerns in almost every case of consequence is to ascertain whether he has a cause of action against persons who have dealt with the bankrupt.[6]

The second reason is that the Trustee, while deriving his rights under Section 70e from those of actual creditors, is not limited in the extent of his recovery to the claims of the creditors upon whom he relies. This is the famous principle of *Moore v. Bay*, 284 U.S. 4 (1931), namely, that if a transfer is voidable at all under state law as against any creditor of the bankrupt holding a provable

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[3]The Trustee also gets title to most causes of action which the bankrupt himself might have brought. Bankruptcy Act, Secs. 70a(5)-(6). This paper, however, will consider only the Trustee's power to invalidate transactions which are valid as between the immediate parties involved.

[4]Section 70e also confers the power to set aside any transfer voidable by creditors under federal law. But this provision is rarely of importance.

[5]Bankruptcy Act, Sec. 1(30).

[6]The schedules and statement of affairs, executed under oath by the bankrupt, Bankruptcy Act, Secs. 7a(8)-(9), disclose to the Trustee most of the transactions which he has the power to attack. Skillful use of the right to thoroughly examine the bankrupt and others who have dealt with him, Bankruptcy Act, Secs. 7a(10); 21a, will provide whatever additional information is necessary for the Trustee's case.

claim, it is entirely void as to the Trustee.[7] A California example will illustrate the point: On January 2, A executed a chattel mortgage in B's favor upon property worth $100,000 to secure a loan made by B in this amount. B, through oversight, delayed in recording the mortgage for 15 days. In the interim, C sold $5 of merchandise to A on credit, but none of A's other creditors came into existence prior to the recordation. A went into bankruptcy two years later without having paid C.

California Civil Code Section 2957 requires prompt recordation of chattel mortgages; otherwise, they are invalid as to creditors extending credit prior to the filing, but good as to all others.[8] Had no bankruptcy occurred, B's tardy recording would not have been serious. When A's Trustee sues under Section 70e, however, he recovers not $5, the maximum risk B faced outside of bankruptcy, but all the property subject to the chattel mortgage, or a money judgment for $100,000 if B has exercised his right of repossession and cannot return the assets in kind.

Failure to record a chattel mortgage is only one of a great many types of omissions which will enable creditors to assail on technical grounds a transaction perfectly valid as between the parties to it.[9] The impact of Section 70e obviously compounds the effect of any mistakes which are made.

Power of a creditor holding a lien by legal proceedings. As to any property on which a creditor of the bankrupt *might* have ob-

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[7]*Moore v. Bay* also stands for a second principle, namely, that the recovery made by the Trustee is to be distributed pro rata to all creditors, in accordance with the distributive provisions of the Act, and not only to those creditors who were entitled to invalidate the transfer outside of bankruptcy. While the decision in the case was announced in the typically cryptic style of Mr. Justice Holmes, a reading of the Ninth Circuit's opinion in *Re Sassard & Kimball*, 45 F.2d 449 (1930), rev'd *sub nom. Moore v. Bay*, leaves no doubt that the Supreme Court established both the propositions above referred to. A number of subsequent holdings by the Courts of Appeal and District Courts spell out the *Moore v. Bay* doctrine more clearly. E.g., *City of New York v. Rassner*, 127 F.2d 703 (C.A. 2, 1942); *Corley v. Cozart*, 115 F.2d 119 (C.A. 5, 1940); *Mercantile Trust Co. v. Kahn*, 203 F.2d 449 (C.A. 8, 1953).

[8]E.g., *Ruggles v. Cannedy*, 127 Cal. 290 (1899). It is to be noted that a creditor whose claim arises before the tardy recording may levy on the chattel mortgaged property even after recordation takes place.

[9]Without attempting an exhaustive list, the following are some other transactions which, though valid as between the parties, are invalid under California law as against certain creditors: A chattel mortgage not executed and acknowledged in accordance with the prescribed formalities, Civil Code Sec. 2957; automobile chattel mortgages where there is no proper compliance with the requirements concerning endorsement of the pink slip and registration of the mortgagee as legal owner, Veh. Code Sec. 195; a bulk sale or mortgage of fixtures or equipment where the requisite notice is not filed and publication made, Civil Code Sec. 3440.1; a transfer of personal property without immediate delivery and continued change of possession, Civil Code Sec. 3440; an assignment of accounts receivable without filing the necessary notice, Civil Code Sec. 3018; a transfer actually or constructively fraudulent under the Uniform Fraudulent Conveyance Act, Civil Code Sec. 3439.09; trust receipt transactions which fail to comply with the statutory requirements, Civil Code Sec. 3016.4; inventory liens which fail to comply with the notice and other requirements of the new factor's lien law, Civil Code Secs. 3030-3043.

tained a lien by legal proceedings on the date of bankruptcy, the Trustee is vested with all of the rights and remedies of such a lien creditor, regardless of whether or not there is actually a creditor of this type in existence. The source of this power is Section 70c of the Bankruptcy Act, frequently referred to as the "strong-arm" clause. Up until quite recently, it was generally believed that Section 70c's main function was procedural.[10] In many situations, creditors who have the right to set aside transfers made by a debtor must first reduce their claims to judgment. Section 70c, by automatically giving the Trustee the status of an execution-lien creditor, obviated the necessity for him to obtain a judgment, and thus he was able to attack the invalid transaction under Section 70e without delay.

When the Second Circuit in 1954 decided *Constance v. Harvey*, 215 F.2d 571, however, the strong-arm clause became of more than mere procedural importance; to the extent that the decision is followed elsewhere, Section 70c provides the Trustee with what is perhaps the most potent weapon in his arsenal.[11]

Constance v. Harvey involved a tardily recorded chattel mortgage which, under the applicable New York law, was void as to creditors of the mortgagor whose claims arose prior to the filing, but valid as to subsequent creditors. Bankruptcy occurred about a year after the recordation. The Court construing 70c literally, held that since a hypothetical creditor might have extended credit to the mortgagor before recordation, and might therefore have been able to invalidate the mortgage on the date of bankruptcy, the Trustee could set aside the security instrument even though no actual creditor possessing such rights existed.

From the Trustee's standpoint, this holding can be of tremendous importance. Applying it to the previous illustration of A's chattel mortgage to B for $100,000, the 15 day delay in filing would make the security invalid as against A's Trustee, despite the fact that he cannot find a creditor such as C whose claim actually arose before recordation. The hypothetical chance that a creditor of this type could exist is enough under *Constance v. Harvey*. The

[10]Where a transfer or other transaction is not perfected at all as against creditors on the date of bankruptcy, a Trustee has always been able to set it aside under Section 70c without resort to other avoiding provisions of the Act. However, until the decision in *Constance v. Harvey*, 215 F.2d 571 (C.A. 2, 1954), discussed in the text, it was never thought that the Trustee could use 70c by itself to invalidate a transfer which had become perfected before bankruptcy.

[11]The Second Circuit itself followed *Constance v. Harvey* in *Conti v. Volper*, 229 F.2d 317 (1956), and the Seventh Circuit independently gave Section 70c the same construction in *In re Kranz Candy Co.*, 214 F.2d 588 (1954). The Ninth Circuit seems to have cited *Constance v. Harvey* with approval in *England v. Sanderson*, 236 F.2d 641, 643, n.7 (1956).

case greatly increases the possibility that a mistake will be fatal if there is not full compliance with the state statutes protecting the rights of creditors, no matter how much time elapses between the error and the date of bankruptcy.[12]

Power to recover preferences. The laws of most states, including California, permit a debtor to prefer one creditor over others without penalty of any kind.[13] The Bankruptcy Act, on the other hand, is not so tolerant. Section 60a defines a "preference" as including seven elements: (1) a transfer (2) of any of the debtor's property (3) to or for the benefit of a creditor (4) on an antecedent indebtedness (5) made while insolvent (6) within four months of bankruptcy (7) the effect of which will be to enable the creditor to receive a greater percentage of his debt than other creditors of the same class. The Trustee, under Section 60b, can recover back any such preference, provided he can prove that when it was made the creditor had reasonable cause to believe that the debtor was then insolvent.

The first element, i.e., the "transfer," includes, among other things, the giving of security of any kind as well as outright dispositions of property.[14] "Insolvency," in the bankruptcy sense, means a condition where the liabilities of the debtor exceed the aggregate fair value of his assets, including both exempt and nonexempt property.[15] The "greater percentage" element is tested as of the date of bankruptcy, and automatically is established whenever a transfer is made to a general unsecured creditor and the bankrupt's estate is insufficient to pay all claims one hundred cents on the dollar.[16]

The requirements that the transfer must occur within four months of bankruptcy, and that it must be for an antecedent debt, have to be read in light of the "perfection test" prescribed by Sections 60(a)(2)-(8) of the Act. These sections provide in essence that a transfer of property other than real estate is deemed to be

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[12]In situations where the belated recordation or other perfection of the transaction protects the transferee against claims of all creditors who have not levied prior thereto, and there has been no actual levy before bankruptcy, the Trustee will be unable to prevail under either Section 70c or 70e. This is the case, for example, under the Pennsylvania chattel mortgage recording law involved in *In re Consorto Const. Co.*, 212 F.2d 676 (C.A. 3, 1954). Most California statutes, however, permit a creditor within the protected class to attack the defective transaction even after the transferee has accomplished the perfection. But compare the interpretation given the California accounts receivable filing statute, and the consequences flowing therefrom, discussd in the text accompanying notes 19 and 20, *infra*.

[13]California law expressly permits preferences. Civil Code, Sec. 3432.

[14]Bankruptcy Act, Sec. 1(30).

[15]Bankruptcy Act, Sec. 1(19).

[16]*Palmer Clay Products Co. v. Brown*, 297 U.S. 227 (1936).

"made" on that date when a levying creditor of the bankrupt could no longer obtain rights in the transferred property superior to those of the transferee.[17] Somewhat surprising consequences flow from this concept, as the following example shows: On January 2, A borrowed $100,000 from B, concurrently assigning to him accounts receivable in this amount as security. B failed to record the notice of assignment required by Section 3018 of the California Civil Code. On July 1, however, B collected the accounts receivable, thus satisfying his claim. A filed bankruptcy on August 1.

At first impression it might seem that the foregoing transaction could not be a preference for at least two reasons: the transfer, i.e., the assignment of the accounts, was actually made for contemporaneous, not antecedent, consideration; and it occurred more than four months prior to August 1. But here the California accounts receivable recording statute comes into play.[18] As construed by the Ninth Circuit, that statute, in the absence of the necessary filing, renders void as against creditors of the assignor any assignment of accounts so long as the receivables remain uncollected. Once collection is effected, however, the assignee is immunized against the assignor's creditors regardless of when their claims arose.[19]

With collection having occurred in July, the Trustee is powerless under either Section 70e or 70c because neither an actual nor hypothetical creditor of the bankrupt-assignor could set aside the assignments in question on August 1, the date of bankruptcy. He is not so impotent under Section 60, however. By virtue of the "perfection" test, the transfer which actually took place on January 2 is deemed to have been made on July 1, the time at which the assignor's creditors lost their ability to invalidate the assignment. This brings the transaction within the crucial four month period. Moreover, when the hypothetical date on which the assignment is deemed to have been made (July 1) is combined with the actual time of B's loan to A (January 2), the result follows that the transfer was given for an antecedent indebtedness.[20] If the remain-

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[17]A transfer of real estate is deemed to be made on the date when it became so far perfected that no subsequent bona fide purchaser from the debtor could obtain rights in the property superior to those of the transferee. Bankruptcy Act, Sec. 60a(2).

[18]Civil Code, Sec. 3018.

[19]*Costello v. Bank of America National Trust & Savings Association*, 246 F.2d 807 (C.A. 9, 1957).

[20]*Corn Exchange National Bank & Trust Co. v. Klauder*, 318 U.S. 434 (1943). At the time of the *Klauder* decision, Section 60 of the Bankruptcy Act contained a bona fide purchaser perfection test for transfers of all kinds of property, whereas at present a levying creditor test is used except in the case of real estate transfers. But results of the kind discussed above can occur regardless of the nature of the perfection test.

ing elements of a voidable preference exist, A's Trustee can recover the $100,000 from B.

In far more cases than might be expected, therefore, Section 60 provides the Trustee with a means of undoing transactions which the parties to them thought they had fully completed.

Power to recover fraudulent transfers. Section 67d(2) of the Act, dealing with fraudulent transfers made within the one year period prior to bankruptcy, confers upon the Trustee some useful avoiding powers. The section contains the same provisions as are found in the Uniform Fraudulent Conveyance Act. Transfers made by the bankrupt with actual, as distinguished from presumptive, fraudulent intent are of course covered. But a number of transactions are declared to be constructively fraudulent even though the participants acted in good faith. Thus, constructive fraud is attributed to (1) any gift or other transfer made by an insolvent debtor within the one year period, where "fair consideration" was not received; (2) to any transfer made without "fair consideration" by a debtor engaged in business, where his remaining property constituted an "unreasonably small capital"; and (3) to transfers made without "fair consideration" by a debtor who believed that he would incur bills beyond his ability to pay as they matured. Additionally, Section 67d(3) of the Bankruptcy Act defines as fraudulent, under certain special circumstances, a transfer made for a fair consideration when the intent was to use the consideration so received to pay a preference to a creditor.[21]

While the term "insolvency" for Section 67d purposes is used in its bankruptcy sense, i.e., an excess of liabilities over assets, the debtor's exempt assets are excluded from the calculation, thus making it easier in many cases to establish the insolvent condition.[22] Like Section 60, 67d contains a "perfection" clause which specifies the date on which the transfer is deemed to have been made. Here, however, a bona fide purchaser, rather than a lien creditor, test is used: The transfer is deemed to take place at the time when no subsequent good faith purchaser from the debtor could acquire

[21]Section 67d(3) has no counterpart in the Uniform Fraudulent Conveyance Act. It declares fraudulent a transfer made by an insolvent debtor, within four months of bankruptcy, if made in contemplation of a bankruptcy or other liquidation, with intent to use the consideration received for the transfer to pay a preference to any creditor, provided the transferee knew of the debtor's intent in this respect. The actual power to avoid the transfers denounced by Sections 67d(2) and 67d(3) is found in Section 67d(6) of the Act. The latter provides that a transfer fraudulent under any of the subsections of 67d as against any creditor of the bankrupt holding a provable claim, is null and void as to the Trustee.

[22]Bankruptcy Act, Sec. 67d(1)(a),(d).

rights in the transferred property superior to those of the fraudulent transferee.[23] This provision, in certain instances, enables the Trustee to attack conveyances under 67d that actually occurred more than one year before bankruptcy.

In the many states, including California, which have enacted the Uniform Fraudulent Conveyance Act,[24] the provisions thereof are available to the Trustee both under Section 67d of the Bankruptcy Act and under Section 70e.[25] The burden of proof, presumptions, and other evidentiary problems may vary, however, depending upon which of the two sections the Trustee asserts.[26] Section 70e sometimes is the more attractive for the reason that the state statute of limitations will apply,[27] and this is normally longer in fraud actions than the one-year limitation period prescribed by Section 67d(2).[28]

Power to invalidate judicial liens. Perhaps the most commonly invoked avoiding power is the one conferred by Section 67a to invalidate certain liens obtained by legal or equitable proceedings upon the debtor's property within four-months of bankruptcy. These liens include those arising by virtue of an attachment, garnishment, judgment or abstract of judgment, execution, creditor's bill and the like. They do not include, however, statutory liens which are specially treated by the Bankruptcy Act and are discussed below.

To prevail under Section 67a, the Trustee need establish only that the lien arose during the four month period and that the bankrupt was then insolvent. If he can do this, the creditor will lose not only his hoped for secured position, but probably also his costs of the levy.[29]

Again, for the purpose of this section, "insolvency" means an excess of liabilities over assets; the debtor's exempt as well as nonexempt property is taken into account in the calculation.[30]

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[23]Bankruptcy Act, Sec. 67d(5).

[24]California's statute is Civil Code Secs. 3439-3439.12.

[25]As noted above, Section 70e enables the Trustee to attack any transfer voidable by creditors under state law. In California, this gives him the benefit of the provisions of Civil Code Secs. 3439-3439.12 as well as the similar powers conferred by Section 67d of the Bankruptcy Act.

[26]See, e.g., 3 Collier on Bankruptcy, Par. 70.94, pp. 1521-1526; Par. 67.43, pp. 450-457.

[27]3 Collier on Bankruptcy, Par. 67.29, p. 328, n. 33, and cases there cited.

[28]California has a three year statute of limitations for actions based on fraud. Code of Civil Procedure, Sec. 338.

[29]As a general proposition, the creditor's costs of attachment, keeper's charges and the like are not considered reimbursable as a first priority expense of administration in any subsequent bankruptcy. 3 Collier on Bankruptcy, Par. 62.24, p. 1542. While the creditor can add these costs to his general claim and file a proof of debt for the entire amount, Bankruptcy Act, Sec. 63a(3), this usually is of little comfort because general unsecured claims, in most estates, are paid small dividends.

[30]Bankruptcy Act, Sec. 1(19).

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Where bankruptcy follows more than four months after the lien arose, the Act does not affect it and the lienholder will be treated as a secured creditor in bankruptcy. In this connection, consider the case of a creditor who attached the debtor's property more than four months before bankruptcy, but obtained his judgment and levied execution within the critical period. The courts have held under such circumstances that since the attachment or original lien was beyond the reach of Section 67a, the Trustee was powerless to set aside the subsequent execution.[31]

Power with respect to statutory liens. The term "statutory lien," although not defined in the Bankruptcy Act, is generally considered to mean that type of lien created by Congress and the various state legislatures for the benefit of specified economic groups or governmental agencies.[32] Tax liens, wage liens, mechanics' liens and those in favor of repairmen, materialmen, warehousemen and landlords are among the most familiar. Stautory liens are to be distinguished from liens arising as a result of a contractual relationship, such as the lien of a chattel mortgage, even though a statute may give recognition to and make effective the agreement of the parties.

The Bankruptcy Act treats statutory liens in a series of overlapping provisions, namely, Sections 67b, 67c(1) and 67c(2). When these are read together and harmonized, the net result can be summarized as follows: Statutory liens on real estate, whether created by federal or state law, are valid as against the Trustee; indeed, where they arise before bankruptcy but are required to be perfected in some manner, such as by filing a notice or commencing suit, perfection can be accomplished by the lienholder even after bankruptcy.[33] State-created tax or other statutory liens on personal property, regardless of when they arise, can be invalidated by the Trustee unless the lienholder has seized or levied on the liened prop-

[31]E.g., *Metcalf v. Barker,* 187 U.S. 165 (1902).

[32]A proposed amendment to the Bankruptcy Act introduced in the last session of Congress as H.R. 5195 by Congressman Celler, would define "statutory lien" as follows: " 'Statutory lien' shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute, and whether or not the agreement or lien is made fully effective by statute."

[33]Bankruptcy Act, Section 67b provides in part: "The provisions of section 60 of this Act to the contrary notwithstanding, statutory liens . . . may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition. . . . Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of the property, they shall instead be perfected by filing notice thereof with the court."

erty prior to bankruptcy. Federal statutory liens on personalty are good as against the Trustee, but are postponed in payment to the bankruptcy expenses of administration and priority wage claims, unless the Government has taken possession of the property before bankruptcy.

Conclusion

The emphasis in this paper on the Trustee's avoiding powers is not intended to convey the impression that these are the only things a person dealing with a prospective bankrupt has to worry about. As noted above, the effect a possible discharge in bankruptcy will have must always be kept in mind. And there are many other considerations as well. Thus, the Trustee may reject executory contracts; occupy the bankrupt's premises for a reasonable period of time, despite provisions in the lease that bankruptcy terminates it; sell property free and clear of a valid encumbrance, transferring the lien to the proceeds; restrain foreclosures and state litigation; supersede assignments for the benefit of creditors and state court receiverships under certain circumstances; and so forth. The attorney's awareness and understanding of the avoiding powers, however, will be a most helpful start in enabling him to protect the client against the disastrous effects which a bankruptcy can bring.

Profit Sharing in Brief

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Most profit sharing discussions deal with the details of particular problems and presuppose at least a basic understanding of profit sharing plans and the laws relating to them. Many, thought by the public to be experts in all phases of law, have little or no knowledge of this phase of law, and may be confounded by the mass of material relating to profit sharing plans. The purpose of this paper is to give the reader some background which may form the basis of an understanding of this phase of law and to point up some of the problems to be dealt with both under the Internal Revenue Code and other relevant laws and regulations.

"Profit Sharing Plan" is a descriptive term which applies to many different types of plans. They range from a bonus type plan wherein an employer shares with his employees a portion of his profits by an immediate cash distribution, to a much more complex plan wherein an employer currently pays to a trustee a portion of his profits to be distributed to the employees at some future time. There are few tax problems in connection with cash profit sharing plans, and this paper is limited to a brief discussion of deferred profit sharing plans.

The Internal Revenue Code and Fair Labor Standards Act require that employer contributions be paid to a trustee in order to have a qualified deferred profit sharing plan. These plans must be operated exclusively for the benefit of employees and may not include owners or directors as such, although they may be included if they are also employees. A sole proprietorship, a partnership or a corporation may institute such a plan. The problems are the same and for simplicity the balance of this discussion refers to corporations.

Profit sharing plans are instituted for various reasons. These are trying times for many employers, and there is a constant need and demand for well qualified top executives to administer and direct our growing and expanding economy. These men may be acquired

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and held by means of increased salary only at a tremendous sacrifice on the part of the employers concerned, because the government takes such a large portion of any additional compensation in the form of individual income tax. For men such as these other means must be adopted. A profit sharing plan wherein an employer may currently obtain an income tax deduction for the amounts contributed, and the employee is not required to pay tax currently on his share is such other means. It must be remembered, however, that any such profit sharing plan will have to cover other employees if Treasury approval and the desired results are to be obtained. Since these plans give employees an interest or a share in the profits of the employer, these plans tend to build morale, increase efficiency so that costs are reduced benefiting both employer and employee, and reduce the turnover of employees covered.

Let us now look at a deferred profit sharing plan and see just what it is. We find we have two elements: A plan and a trust. The plan contains the meat, that is, it provides for the contributions by the employer, eligibility of employees, the manner of payment of benefits and the other problems which we shall touch upon later. The trust itself provides for the rights and duties of the trustee as in any other trust, except that the trustee is generally told by the

benefit committee how, when and to whom to make distributions. The plan and trust may be embodied in separate documents or together in one document. A corporate trustee is usually used and we shall not here delve into any of the problems of using an individual trustee.

Now let us look at some of the component parts of the plan. The plan should provide for a benefit committee which usually exercises the discretionary powers permitted in the plan and makes most of the decisions. The benefit committee interprets the plan and passes on questions of fact, and in so doing determines eligibility of employees, determines the allocation of contributions to the various employees' accounts, notifies the trustee when and to whom to make distribution and may have the power to determine the method of distribution of benefits. In some plans the trustee is given complete power of investment; that is, it is incumbent upon the trustee to make investments as it deems best. Many plans, however, provide that the trustee shall make recommendations as to investments and that the benefit committee has final authority to direct the trustee in making the investments. Corporate trustees usually have their investment committee make recommendations and after the investments are made, whether the recommendations are followed or not, the committee watches the investments and makes further recommendations to change investments when the need arises. Still other plans provide that the benefit committee shall make the investments. In this situation the trustee makes no effort, and has no authority, to make any suggestions as to investments and once investments are made it does not watch the investments or make suggestions when prudence may require a change.

The Internal Revenue Code specifies that if the plan is to qualify, the plan may not discriminate in favor of employees "who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees." This forms the basis of many of the rules of the Internal Revenue Service in respect to eligibility and the operation of the trusts. The Service requires, in general, that an employee become a participant within a period of 1 to 5 years from the commencement of his employment. If employees become participants within a very short period of time there will generally be many forfeitures, and the officers, shareholders and other highly compensated employees, who do not tend to terminate, would share in

all of these forfeitures and the plan may be deemed thereby to discriminate in favor of such employees. Also if too great a time must pass in order for employees to become a participant, participation may be limited to supervisory personnel.

The Internal Revenue Code in Section 401 (a) (3) provides for certain tests of eligibility under which it is determined that there is no discrimination in favor of employees who are officers, shareholders, etc. The plan will be disqualified unless 70 per cent or more of all employees, excluding part time and temporary employees, participate in the plan or 80 per cent or more of the employees eligible participate and 70 per cent of all employees are eligible to participate. That section further provides that irrespective of the foregoing percentages a profit sharing plan may extend to a class of employees found by the Secretary of the Treasury or his delegate to be nondiscriminatory. Such a classification may be by department, plant location, salaried and clerical employees, hourly employees or other similar classifications.

The funds to finance the plan are received by the trustee in the form of contributions by the employer. The plan is required to contain some formula to determine the amount of contributions to be made. One of the great advantages of a profit sharing plan is that it is tied to profits, that is, if there are no profits, there is no contribution; and thereby the employer is not required to make an annual contribution irrespective of profits, and perhaps ability, as must be done with pension plans. The Internal Revenue Code limits the amount of the employer's deduction to 15 per cent of the compensation paid to the participating employees, this therefore is usually an overriding limitation contained in the formula. Other elements in the formula depend upon the generosity of the employer and perhaps his estimate of future profits in relation to this 15 per cent limitation. It is pointed out that it is now permissible to have a discretionary formula, or a definite formula specifying a minimum amount of contribution and giving the Board of Directors power to determine additional amounts of contribution up to the overall maximum of 15 per cent of compensation paid to participating employees. P. S. No. 57 requires that the Internal Revenue Service be notified of any curtailment of a plan; such notification should be made in the event of a change from a definite formula to a discretionary formula.

Although it is not very common it is permissible for a profit sharing plan to be contributory on the part of employees.

The plan must provide for allocation of the contribution to the accounts of the participating employees. The allocation may be made on any one or a combination of various bases. A very common basis of allocation is the use of the ratio of a participating employee's compensation to that of all participating employees. The employer may wish to weight the allocation for years of service. In this event the Internal Revenue Service requires additional information as provided for in I. T. 3685. The required information is a table which attempts to demonstrate the ratio of allocated contributions to salary in various salary range groups. If the allocation clearly favors the higher paid employees some change will have to

be made in order to obtain Internal Revenue Service approval. It may be necessary to reduce the effect of the weighting for years of service, or perhaps, to consider an employee as participating in the plan only to the extent of a certain maximum amount of his salary; such as, a provision that an employee may participate in the plan to the extent of his first, say, $15,000 of income. The allocation of trust income and expense and the unrealized gain or loss determined by the annual revaluation of trust assets may be distributed based on the account balances as of the beginning of the trust year. Forfeitures and other contributions may not be allocated in this manner, but should be allocated in a manner similar to the allocation of the contributions. The allocation of forfeitures based on account balances would generally be appropriate for the first few years of the plan. But after a short time the account balances of the long term and more highly paid employees build up faster than balances of other employees and therefore allocation in this manner would tend to discriminate in favor of these more highly paid employees.

Usually, employees do not have an absolute or indefeasible right to the amounts allocated to their accounts. Once an employee becomes a participant it is common for his interest to vest at the rate of 10 per cent a year in the portion of the trust estate represented by his individual account. The vesting of one's account in this manner makes it desirable for an employee to continue working for an employer in that the longer he stays with the employer the greater portion of the growing amount in his account he will be able to take with him when he retires or terminates. It is common also to provide for 100 per cent vesting in the event of death, permanent disability or retirement.

It is common for the benefit committee to determine the manner and the form of distribution to an employee under the various circumstances. Quite often the committee has the discretion to distribute either in lump sum or in installments over a period of years. There is also the discretion to determine whether the payment shall be made in cash or in securities and investments of the trust estate, or in some form of insurance or annuity contract. Some plans provide that the participating employee may make certain of these decisions. In still other plans there may be no discretion as to the

Recent Buyer to Escrow Officer:

"I've just received the deed to the land I bought through your escrow. You seemed so understanding that I felt I could ask you to help me again. I'm a widow and my children are 14 and 16. My neighbor told me all about joint tenancy deeds. Would you draw one up for me so that the children and I could all be joint tenants?"

Escrow Officer:

"I'm glad you came back to see me, for it gives me the opportunity to urge that you discuss that joint tenancy suggestion with your lawyer. You might find some unexpected delay and other unexpected features of land ownership by minors, should you want to sell or borrow money. Don't go near that neighbor again until you have seen your lawyer."

manner or method of payment; that is, a plan may provide for a lump sum death benefit or perhaps installment payments on termination.

Although the plan must be intended to be permanent in order to qualify, it is common to provide that the plan is voluntary and may be terminated at any time, or that the employer may discontinue contributions to the plan, if it is determined that the plan is not achieving the desired results. In the event of discontinuance of contributions or the termination of the plan, the interests of all participants must vest in their entirety.

As has been indicated earlier, there are tax advantages to be obtained from qualified profit sharing plans. The employer is entitled to an income tax deduction for the year, with certain exceptions, in which the contribution is paid to the trustee; but the employee does not recognize as income his pro rata share of the contribution in that year. Employees realize income only when they receive benefits under the plan, presumably at retirement, when income is low and the benefits are therefore taxed at low rates. If distribution of benefits is made in lump sum the beneficiary is entitled to capital gains treatment and is not taxed at ordinary rates. These plans, therefore, have obvious advantages in offering more to executives without the government taking the lion's share of the increase, and without prohibitive costs to the corporation. Another tax andvantage is that the trust, if exempt, may accumulate funds and profits, with certain exceptions, without tax liability. The trust is not only per-

mitted, but required, to invest the employer contributions. The only limitation in the Internal Revenue Code as to investments is the general proviso that the trust must be operated for the exclusive benefit of employees. The Code imposes tax liability on the income from any unrelated trade or business regularly carried on, but excludes from this provision income from most investments, such as dividends, interest and rents. Business income, such as sale of goods held primarily for sale to customers in the ordinary course of business, is subject to the tax.

To help in the assurance that the trust is operated for the exclusive benefit of employees, the Code lists certain prohibited transactions, such as loaning funds to the employer-creator without adequate security or at less than a reasonable interest rate. The consequences of entering a prohibited transaction are that the trust will be disqualified, subjecting the trust to tax on all of its income and denial to the employer of the deduction for his contribution. Generally the disqualification will be effective for taxable years after the year in which the Internal Revenue Service notifies the trust that it has engaged in a prohibited transaction. A trust in this situation is not forever foreclosed, but may file claim for exemption and again become qualified.

A discussion of this type would not be complete without mentioning other laws which affect profit sharing plans.

Unless expressly excluded by contract, these plans are subject to negotiation with the bargaining agent of participating employees.

The benefits are included in "wages and working conditions" which the Labor Management Relations Act states are subject to negotiation.

The U. S. Department of Labor's Wage and Hour Division has regulations covering qualification of profit sharing plans and employee benefit plans. If the plan is qualified by the Internal Revenue Service, and the benefits provided are of the specified types, the plan will qualify as a benefit plan. The Wage and Hour regulations for a qualified profit sharing plan are much more stringent, and as a result qualification as a benefit plan is usually claimed. If a plan does not qualify, each employee's pro rata share of contributions must be included in his regular rate of pay which is used for computation of overtime payments. It is readily seen that an employee who works much overtime can build up substantial amounts of unpaid wages over a period of time and it could be very expensive if many employees asserted their claim for unpaid overtime. The most expensive element is the cost of determining the amounts due.

In the average case of a small company there is no problem with the Securities Exchange Commission or other bodies regulating the sale or issuance of securities where the employees do not contribute to the trust. Such a problem should not be overlooked, however, in those instances in which the employees do contribute.

Profit sharing and other employee benefit plans affect a great many other laws in collateral ways; such as, the allowance of such costs on contracts under the Armed Services Procurement Regulations and the renegotiation of contracts.

In conclusion, it is pointed out that the problems of qualification of these plans arise again each time the plan or trust is amended. Approval of the various provisions does not guarantee that the provisions will always be acceptable as the plans must be brought up to date incorporating changes and additions in the law and its interpretation.

What's Doing Around the County?

It is hoped that this column, dealing with the activities of the affilliated associations in Los Angeles County, will appear henceforth in the Bulletin. Items of interest should be submitted to the Bar Bulletin Committee.

Santa Monica: The Santa Monica Bay District Bar Association celebrated "Federal Night" last September 8 at the Fox & Hounds Restaurant in Santa Monica. Speaker was the Hon. Ernest A. Tolin. Guests included United States Attorney Laughlin E. Waters, Santa Monica Postmaster Elmer H. Dean, Mr. J. H. Johnson, District Manager of the Santa Monica Social Security Office, and Mr. D. K. Brown, Agent in Charge of the Los Angeles office of the F.B.I.

Long Beach: The Long Beach Bar Association will hold a meeting at the Lafayette Hotel, in Long Beach, on October 24, with the social hour commencing at 6:30 p.m. Dinner will follow at 8. The meeting will be held in conjunction with local doctors. The Bulletin is informed that, mercifully, there will not be a panel discussion of whiplash cases. There may be some discussion as to the proper mixture for martinis.

Beverly Hills: The Beverly Hills Bar Association and the Federal Bar Association jointly sponsored, with the University of California Extension, a continuing education program on Government Contracts and Subcontracts at U.C.L.A. on September 19 and 20. Enrollment was 425.

Dr. Stewart Know addressed the association on "Is Narcotics Addiction a Legal Problem?" at the September 18 meeting of the association at the Beverly-Wilshire Hotel. A committee of the association, consisting of Robert Neeb, Jerry Geisler, David Heyler, Jr., and Marvin Freeman, was appointed to study the problem and recommend remedial legislation, if appropriate.

At press time, the expected speaker for the October 15 luncheon meeting, at the Beverly-Wilshire Hotel, is Senator Kuchel.

STATEMENT REQUIRED BY THE ACT OF AUGUST 24, 1912, AS AMENDED BY THE ACTS OF MARCH 3, 1933, AND JULY 2, 1946 (Title 39, United States Code, Section 233) SHOWING THE OWNERSHIP, MANAGEMENT, AND CIRCULATION OF

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1. The names and addresses of the publisher, editor, managing editor, and business managers are:

Publisher—Los Angeles Bar Association, 510 S. Spring St., Los Angeles 13, Calif.

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Business Manager—Robert M. Parker, Jr., 241 E. Fourth St., Los Angeles 13, Calif.

2. The owner is: (If owned by a corporation, its name and address must be stated and also immediately thereunder the names and addresses of stockholders owning or holding 1 per cent or more of total amount of stock. If not owned by a corporation, the names and addresses of the individual owners must be given. If owned by a partnership or other unincorporated firm, its name and address, as well as that of each individual member, must be given.) E. Avery Crary, President, 612 S. Flower St., Los Angeles 17, Calif.; A. Stevens Halsted, Jr., Secretary, 621 S. Spring St., Los Angeles 14, Calif.; Frank C. Weller, Treasurer, 111 W. Seventh St., Los Angeles 14, Calif.; Los Angeles Bar Association, Publisher, 510 S. Spring St., Los Angeles 13, Calif.

3. The known bondholders, mortgagees, and other security holders owning or holding 1 per cent or more of total amount of bonds, mortgages, or other securities are: (If there are none, so state.) NONE.

4. Paragraphs 2 and 3 include, in cases where the stockholder or security holder appears upon the books of the company as trustee or in any other fiduciary relation, the name of the person or corporation for whom such trustee is acting; also the statements in the two paragraphs show the affiant's full knowledge and belief as to the circumstances and conditions under which stockholders and security holders who do not appear upon the books of the company as trustees, hold stock and securities in a capacity other than that of a bona fide owner.

5. The average number of copies of each issue of this publication sold or distributed, through the mails or otherwise, to paid subscribers during the 12 months preceding the date shown above was: (This information is required from daily, weekly, semiweekly, and triweekly newspapers only.)

ROBERT M. PARKER, JR.,
Business Manager.

Sworn to and subscribed before me this 26th day of September, 1958.

[Seal] MARGARET H. FALES

My commission expires January 11, 1962.

Notary Public in and for the County of Los Angeles, State of California

end